

Pablo Spiller's comments on "Preparatory Fieldwork Proposals for Designing Institutions  
for SME-Friendly Trade Liberalization"

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**I. Introduction**

In this note I present some comments to the papers presented at the IRIS/USAID conference on May 30, 2002. The purpose of this conference was to present a possible IRIS research agenda on the area of trade liberalization and small medium enterprise with the purpose of providing USAID with a manual, based on the New Institutional Economics paradigm, on how to develop and implement donor programs. Thus, in this brief note I do two basic things. First, I present a brief sketch on what does NIE tell us about how to structure donor activities. Second, I make some general comments about the proposed research agenda.

**II. A New Institutional Economics Approach to Donor Activities**

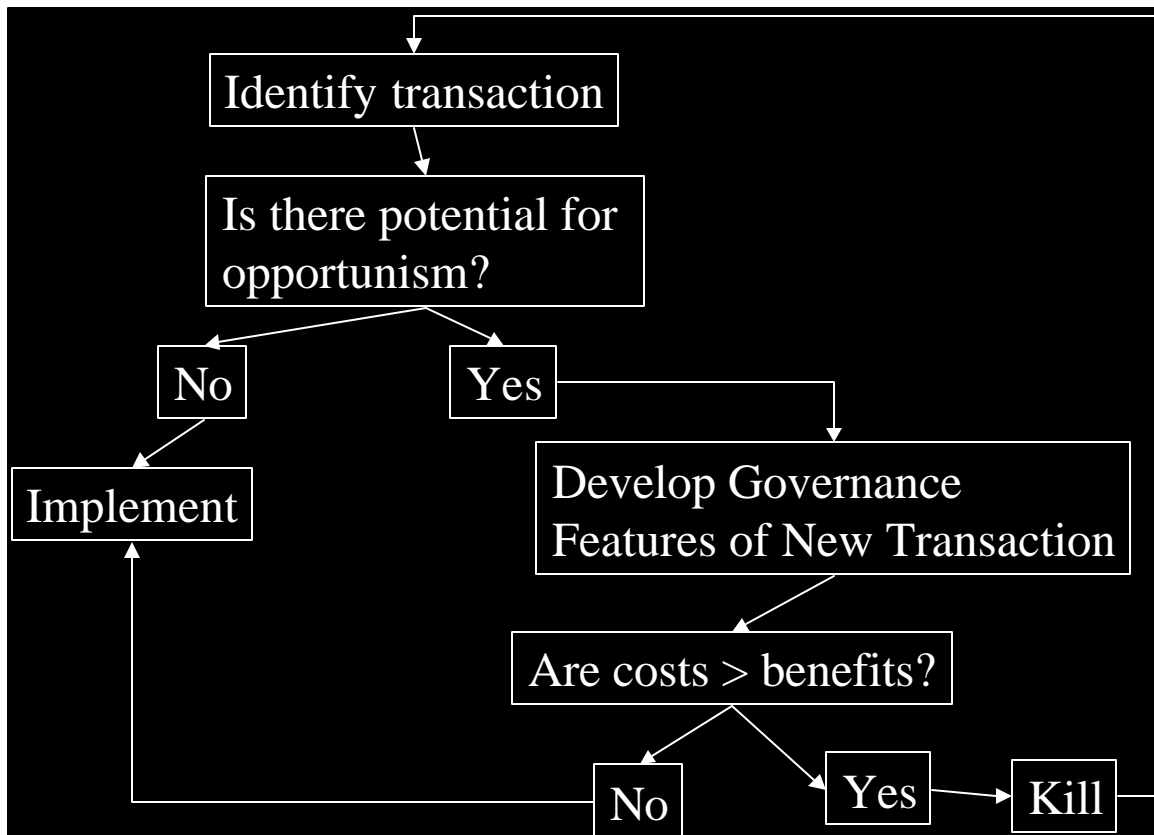
The use of NIE for the design and implementation of donor activities is a fascinating thought. Donor programs usually are undertaken with little understanding of the politics and the incentives of those who have to implement the particular program. Thus, most often programs tend to fail, creating the perception of corruption or incompetence of the implementing parties, when in reality the lack of success could have been forecasted simply by a proper understanding of the nature of the program at hand and the incentives of the players.

Transaction costs economics, which is the foundational stone of NIE, uses a transaction as the unit of analysis. Such approach is perfect for donor activities. In this case the unit of analysis has to be the program, or more specifically, the contract between the government and USAID. TCE also emphasizes that the key endogenous variable is the governance of the transaction, in other words, the safeguards which were developed to assure that the transaction takes place along the desired lines by both parties. These safeguards, in turn, depend on two basic features: the features of the transaction – timing of the transaction, incentives for renegeing or opportunistic behavior by the recipient, and the nature of the institutional environment. The institutional environment is fundamental as the workings of political institutions impact on the incentives of the political players as well as restricts the set of strategies that they may use. The key purpose of safeguards is then to limit opportunistic behavior. Thus, as it relates to donor programs, it is important whether the program is a long term or one shot program, whether there are or not implementation restrictions, whether a single or multiple contractors can be used, the extent of close management, as well as disbursement schedules. All these features affect the nature of the transaction.

Now governance development may impact on the performance of the agreement, and thus, it may have to be recomputed. The safeguards may change the benefits and costs of the program and in particular the program may be found to be non-implementable.

### III. Applying NIE to Trade Liberalization and SME Participation Programs

In thinking about how USAID may help improve SME participation in trade liberalization programs it is important to understand that each transaction is very country specific. Trade liberalization normally is undertaken by the country without the USAID having a big say on how it may be implemented as a whole. Thus, the issue, in identifying programs the USAID may develop to help SME participation must follow an analytical screening which consists on identifying the main barriers for SME expansion, whether they are the workings of farm cooperatives, or the banking system, of NGOs, of the infrastructure sector, of the legal system (including bankruptcy). Once the particular barrier for SME participation has been identified for the specific country, NIE may be called to help develop the particular features of the donor program. The following flow chart helps figure out how to implement it.



To understand the potential for political opportunism, it is important to understand the workings of political institutions, what Mariano Tomassi and I call “Institutional General Equilibrium.” Essentially, USAID deals with implementing programs that affect public policy. To understand public policy and its impact, it is important to understand how it is

done. There are two factors here that are exogenous to this model: history (cf. Greif and North) and the institutional environment. The two of these make an impact on how political institutions actually operate and work. This combination of the working of political institutions, the institutional environment, and beliefs affects real incentives, which affect the parties' investments, and thus the need for the development of governance features, which eventually affect the program's performance.

Now, there is a feedback loop between current institutions and the institutional environment. This particular loop does not operate as easily and fluidly as one might hope. The institutional environment is hard to break or reform simply because it provides the incentives to the political players who work within the political institutions and make their living from this institutional environment. Changes in the institutional environment will make those actors obsolete, or will change their rents. Consequently, those actors resist reform. The extent by which the actors resist reform, however, depends also on the current circumstances. In crisis environments some reforms may be easier to implement than when circumstances are relatively calm. On the other hand, calm environments may facilitate the design of programs. Thus, successful implementation requires a clear understanding of economics, politics and art. Economics allows us to assess which proposals make a society better off. Politics allows us to understand the workings of the institutional environment. And art allows us to simplify these ideas and communicate them clearly. Communications is crucial if the program is to be successfully implemented.

In sum, this project should give more attention to understanding how political institutions work in each of the selected countries. Otherwise, no proposal will work because, as from Institutional General Equilibrium, any small change to the equilibrium will not stick, but revert back to the previous state of things. So it is imperative to understand the general political environment before making any changes to it.

#### **IV. Implications for the Proposed Research Program**

The proposed research program is a mixed bag of pet projects, each of which could constitute a doctoral dissertation. The proposed program lacks a theoretical framework as well as an empirical focus, and it is uncertain the extent by which it can implemented, and if implemented what lessons can be derived from it. Indeed, the prior discussion implies that NIE requires close attention to detail. Large cross-country analysis with poor date of badly conceived hypotheses is a recipe for disaster. The research project should not try to learn about trade liberalization. IRIS has no particular expertise on this topic, and the World Bank is probably the place to do so, if they haven't done it already. IRIS should use its competitive advantage—which is not on trade, but institutional analysis. This is the focus the research program should take. But this must be done limiting the enthusiasm for applying NIE to every feasible or interesting topic. Each country has its own features, and NIE can be utilized to uncover them.

Now as it relates to the results from the project. The result of the research project should not be a “USAID NIE cook-book.” Not only such a cook-book cannot be developed, but even if developed will only generate wrong applications. The purpose of this project is to teach USAID program managers and staffers how to conduct NIE research as it applies to particular donor programs. These managers and staffers will, in turn, by their actions, disperse the knowledge within USAID, and eventually NIE will be applied in a “matter of fact” way to the design and implementation of USAID programs.

Thus, to summarize, the research project has to be redesigned. It has to be drastically downsized. The theoretical framework has to be developed, and empirical applications to a few countries have to be seriously considered.